BEFORE THE UNITED STATES
DEPARTMENT OF THE INTERIOR
MINERALS MANAGEMENT SERVICE

American Petroleum Institute Comments on Minerals Management Service Proposal for Valuation of Crude Oil and Sale of Federal Royalty Oil

62 FR 3742 (January 24, 1997)
30 CFR Parts 206 and 208

VOLUME 1 - COMMENTS

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American Petroleum Institute
Comments On Minerals Management
Service Proposal for Valuation of Crude Oil
and Sale of Federal Royalty Oil
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Vice President and
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May 27, 1997

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Dear Mr. Guzy:

API is a national trade association whose over 300 members are engaged in all aspects of the petroleum industry: exploration, production, transportation, refining and marketing. Many of API's members are actively engaged in activites involving crude oil produced on federal lands. They account for the vast majority of crude oil royalties paid every year and have a substantial interest in the MMS' January 24, 1997 proposal ("Proposal").

As our attached detailed comments show, the MMS Proposal poses major problems at several levels. In a nutshell, the MMS Proposal for valuation of crude oil is too costly, does not work and exceeds the MMS' statutory authority. Moreover, the rulemaking process employed is rife with procedural problems and draws the MMS' energy away from real solutions, namely, revision of the existing regulations and/or development of a viable royalty-in-kind program.

The Proposal would scrap the existing regulations for valuation of crude oil in favor of an untried and hopelessly flawed indexing scheme. If the MMS perceives problems with the existing regulations, it should instead consider revisions to the existing regulations and fully explore a viable royalty-in-kind program. When the MMS held its royalty-in-kind public meetings on March 18 and 19, 1997, they stimulated considerable interest among oil companies of all types who, no less than the MMS, would like to see an end to the uncertainty and controversy inherent in any valuation scheme. When the MMS convened its April 15 and 17, 1997, public hearings on the

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Proposal, interest in exploring the royalty-in-kind option, if anything, had increased among the oil industry. Our comments today identify core attributes of a viable royalty-in-kind proram and we urge you to explore it fully instead of the present Proposal.

As to the substance of the Proposal itself, it unnecessarily contracts the use of gross proceeds, whether realized through arm's-length contracts or a wide variety of other transactions, all of which play an important role in today's complex crude oil market, which has many players quite differently situated. If revisions to the existing regulations are called for, so be it. But do not "throw the baby out with the bathwater."

In more specific terms, the MMS Proposal would adopt an index-driven scheme whose operation would impose on producers and other entities a substantial administrative burden wholly out of proportion to its purported benefits and inconsistent with the Paperwork Reduction Act. In separate comments submitted to OMB and incorporated in these comments, we showed that the MMS Proposal would necessitate the collection of huge amounts of data and require extensive reworking of existing royalty administration systems without any tangible increase in benefits that we can perceive.

More fundamentally, the MMS Proposal simply cannot work. With its dependence on NYMEX and ANS prices far removed from the market at the lease, the proposed index-driven scheme simply starts at the wrong end of the market. And the simplistic adjustment mechanisms proposed cannot begin to bridge the gap between index prices and prices realized at the lease market. As a result, the proposed scheme is not only dysfunctional but exceeds the MMS' legal authority to collect royalties in the amount or value of the production saved, removed or sold "from the lease." Not only would the Proposal unlawfully lead to a value different than the value of production at the lease, but it attempts to "clarify" that the lessee's existing duty to place production in marketable condition also includes the duty to market free of charge to the lessor.

Finally, if the MMS expects stakeholders to comment meaningfully on its proposals, it needs to disclose fully the centrally relevant material underlying them. In this case, the Proposal itself offered little hard information beyond vague allusions to experts and unsubstantiated assumptions. This necessitated the filing of a joint trade association Freedom of Information Act, which unfortunately has not yielded all of the needed information with enough time for thoughtful review and commentary. If the MMS elects not to abandon this rulemaking, the MMS should at least publish a new proposal without the obvious flaws of the present proposal and disclose the information the pubic needs for meaningful review and comment.

Sincerely,

G. William Frick

G. William Frick

c: C. Quarterman
L. Querques
D. Sant.

American Petroleum Institute Comments on Minerals Management Service Proposal for Valuation of Crude Oil and Sale of Federal Royalty Oil 62 FR 3742 (January 24,1997), 30 CFR Parts 206 and 208

API is a national trade association whose over three hundred company members are engaged in all aspects of the petroleum industry: exploration, production, transportation, refining and marketing. Many of API's members are engaged in exploration, production and transportation activities involving crude oil produced on Federal lands, account for the vast majority of crude oil royalties paid, and have a significant interest in the MMS' proposal published at 62 FR 3742 (January 24, 1997)("Proposal")[1].

I. The MMS Proposal Has Profound Procedural Flaws

A. Substantial and Unjustified Paperwork Burden

Comments submitted to OMB[2] on the the Paperwork Reduction Act implications of the MMS' January 24, 1997 Proposal, and subsequently endorsed by API[3], show plainly that implementation of the rule as proposed would impose substantial costs, uncertainty and inequities on the private sector.

Specifically, the Proposal contemplates new filing requirements which would cause the lessees and the MMS to incur significant filings and necessitate costly revisions of complex administrative, accounting and recordkeeping systems. These costs are compounded because of inequities associated with the

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1 *See* **Attachment A**.

2 "Preliminary Analysis of the Department of the Interior, Minerals Management Service Proposed Rule establishing oil Value and Royalty Due on Federal Leases and on Sales of Federal Royalty Oil," enclosed with letter to OMB, from Domestic Petroleum Council, Independent Petroleum Association of America, Mid-Continent Oil and Gas Association and Rocky Mountain Oil and Gas Association, dated March 25,1997(**Attachment B**).

3 Letter to OMB from American Petroleum Institute, dated April 9,1997(**Attachment C**).

sweeping scope of the requirements and because of the Proposal's myriad uncertainties. Finally, these costs would be magnified further if the MMS were to adopt an Interim Final Rule approach whereby requirements imposed at the outset were altered soon after the initial requirements were issued.

This cost impact alone, irrespective of the many other procedural, factual, legal, and workability flaws of the Proposal, justifies an MMS reassessment of the Proposal and, at the very least, publication of a significantly revised new proposal.

B. Failure to Disclose Centrally Relevant Information

The Proposal contemplates a valuation methodology which is not only complex but represents a radical change from well-established crude oil valuation practices woven deeply into the MMS' existing regulations. However, the failure to disclose centrally relevant information and to give stakeholders ample time to review the proposal and its underlying information thwarts meaningful review.

The preamble to the Proposal states:

> MMS used various sources of information to develop the proposed rule. In addition to comments received on the Advance Notice of Proposed Rulemaking, MMS attended a number of presentations by: crude oil brokers and refiners, commercial, oil price reporting services, companies that market oil directly, and private consultants knowledgeable in crude oil marketing. MMS' deliberations were greatly aided by a wide range of expert advice.[4]

Notwithstanding this litany of diverse sources, the Proposal identifies with specificity no material, other than the public comments submitted on the ANPR. Yet, as the joint association Freedom of Information Act request shows, the

[4] Proposal at 3742.

Proposal is shot through with core assumptions and conclusions whose bases are either not clearly disclosed or are undisclosed altogether.[5]

Given the complexity of the Proposal and its radical departure from the MMS' existing regulations, such unexplained assumptions and conclusions deprive stakeholders of a meaningful opportunity to review the Proposal. In an attempt to close this information gap, API and other associations filed the February 28, 1997, Freedom of Information Act request referred to above. And, while the Department of the Interior purports to have complied with that request, the response falls well short of the full disclosure needed for meaningful public review and comment. The FOIA-related information released to date, while relevant, is plainly incomplete, carries no explanation of its linkage to the Proposal, and has only become available toward the end of the public comment period.[6] As a result, the Proposal does not satisfy well-established principles for notice under the Administrative Procedure Act ("APA").

In Home Box Office, Inc v. FCC, the D.C. Circuit observed that ". . . the notice required by the APA, or information subsequently supplied to the public, must disclose in detail the thinking that has animated the form of a proposed rule and the data upon which that rule is based."[7] "An agency proposing informal rulemaking has an obligation to make its views known to the public in a concrete and focused form so as to make criticism or formulation of alternatives possible."[8]

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[5] Freedom of Information Act request filed by API *et al.*, dated February 28, 1997, item 11 at 8-9 (**Attachment D**).

[6] *See* Letters dated March 14,1997 and April 8,1997, from G. K. Kann, MMS, to Ms. Bragg, counsel for API *et al.*; *appeal filed* May 6, 1997.

[7] Home Box Office,Inc. v. FCC, 567 F.2d 9, 35 (D.C. Cir. 1977), *cert. denied*, 98 S. Ct.111, *reh'g denied*, 98 S.Ct. 621.

[8] *Id.* at 35.

In Connecticut Light and Power Co. v. NRC, the D.C. Circuit added:

> If the notice of proposed rule-making fails to provide an accurate picture of the reasoning that has led the agency to the proposed rule, interested parties will not be able to comment meaningfully upon the agency's proposals. . . .In order to allow for useful criticism, it is especially important for the agency to identify and make available technical studies and data that has been employed in reaching the decisions to propose particular rules. To allow an agency to play hunt the peanut with technical information, hiding or disguising the information that it employs, is to condone a practice in which the agency treats what should be a genuine interchange as mere bureaucratic sport.[9]

Citing Home Box Office and Connecticut Power & Light, Florida Power & Light Co. v. United States states that "notice must not only give adequate time for comments, but also provide sufficient factual detail and rationale for the rule to permit interested parties to comment meaningfully."[10]

In response to industry's request for a reasonably complete picture of the proposal, what the MMS has given industry so far is a jigsaw puzzle, unassembled and with many of the pieces missing. To satisfy the minimum due process requirements of the APA, the MMS must do something which offers stakeholders more essential information and more time. After close of the present comment period, we urge the MMS to publish a new proposal more clearly linked to the agency's source material and reflecting the preliminary comments it receives from stakeholders.

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[9] Connecticut Light and Power Co. v. Nuclear Regulatory Commission, 673 F.2d 525 (D.C.Cir.1982).

[10] Florida Power & Light Co. v. United States, 846 F.2d 765 (D.C.Cir.1988).

C. No Basis for Shortcircuiting Informal Rulemaking Procedures Through Use of an Interim Final Rule

The preamble states that: MMS may publish an Interim Final Rule while it further evaluates the methodology in this proposed rule. This approach would provide the flexibility to do a revision after the first year without a new rulemaking."[11]

If ever there was a rulemaking unsuitable for the shortcircuiting of informal rulemaking procedures through publication of an interim final rule, it is this rulemaking.

The APA does state that the prescribed minimum requirements of notice-and-comment rulemaking procedures do not apply:

> (A) to interpretative rules, general statements of policy, or rules of agency organization, procedure, or practice; or
>
> (B) when the agency for good cause finds (and incorporates the finding and a brief statement of reasons therefor in the rules issued) that notice and public procedure thereon are impracticable, unnecessary, or contrary to the public interest.[12]

Of the two kinds of exceptions, it seems evident that only the "good cause" exception is even potentially applicable to the present rulemaking. And while the MMS at this juncture has offered no legal justification whatsoever for such a shortcut, some well-established APA principles are noteworthy.

First, myriad Federal court decisions make it clear, as a general matter, that the statutory exceptions to the APA informal rulemaking requirements should be narrowly construed.[13] And the "good cause" exception is no different.[14]

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[11] Proposal at 3743. Indeed, proposed §206.102(c)(3) contemplates monitoring NYMEX and ANS index prices and establishing by rule a substitute valuation method if "MMS determines that NYMEX or ANS spot prices are unavailable or no longer represent reasonable royalty value." Proposal at 3753.

[12] APA § 553(b)(3); 5 USC § 553(b)(3)(emphasis added).

[13] *See, e.g.*, Flagstaff Medical Center, Inc. v. Sullivan, 962 F.2d 879, as amended(9th Cir. 1992).

Nothing suggests that, for the crude oil valuation rule here, normal rulemaking would be "impracticable,"[15] "unnecessary,"[16] or "contrary to the public interest." [17]

In sum, the MMS should abandon any further consideration of adopting an interim final rule for the complex, radical change in crude oil valuation methodology reflected in the Proposal then issuing a revision without further rulemaking. Given the importance of this rulemaking and its demonstrably significant cost implications, the agency should eschew any "trial and error" approach in favor of a more deliberative process. This process should carefully determine whether a revision to the existing regulations is needed at all and, only then, carefully assemble an appropriate regulation where further revisions of substance are unlikely.

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[14] *See* Alcaraz v. Block, 746 F.2d 593 (9th Cir. 1984) (agency may not use "good cause" exception to manipulate procedures to its own use); *see also* U.S. Steel Corp. v. U.S.E.P.A.,595 F.2d 207(5th Cir. 1979), *rehearing granted*, 598 F.2d 207 (agency may not use "good cause " exception whenever it finds it inconvenient to comply).

[15] The existing regulations were the subject of several rulemaking proposals. *See* discussion under Part III-A, *infra.*

[16] *See* State of S.C.ex rel Patrick v. Block, 558 F. Supp. 1004 (D.S.C.1984) ("Unnecessary " criterion confined to those situtions in which administrative rule is routine determination, insignificant in nature and impact and inconsequential to industry and to public); *see also* discussion under Part I-A, *supra.*

[17] Under the existing regulations and applicable mineral leasing statutes, the Department wields full authority to enforce compliance with lessee royalty obligations. *See, infra,* Part III-A .

II. The Administrative Record Does Not Support Abandonment of Existing Crude Oil Valuation Regulations

In 1988, the MMS promulgated the existing regulations for valuation of crude oil. They were the product of deliberations by the Department of the Interior's first Royalty Management Advisory Committee and several rulemaking proposals.[18]

Basically, for oil production sold pursuant to an arm's-length contract, the existing regulations provide that, for royalty puposes, value is the gross proceeds accruing to the lessee, less approved allowances (*e.g.*, for transportation).[19] For oil production not sold pursuant to an arm's-length contract. the existing regulations employ a carefully constructed, ordered hierarchy of valuation benchmarks whose applicability depends on the particular circumstances: the lessee's contemporaneous posted price or comparable arm's-length contracts, the arithmetic average of other persons' contemporaneous posted prices, the arithmetic average of contemporaneous arm's-length contracts, prices received for arm's-length spot sales, net back or any other reasonable method.[20]

As a safety net, the existing regulations require the lessee to use the benchmarks even for arm's-length contracts where the MMS determines that the gross proceeds accrued do not reflect the "total consideration."[21] In addition, the existing regulations make it clear that even use of the benchmarks does not preclude the MMS from requiring the lessee to use a different value in certain

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[18] 53 FR 1184 (January 15, 1988), 52 FR 30826 (August 17, 1987), 52 FR 35451 (September 21, 1987).

[19] 30 CFR § 206.102(b(1)(i).

[20] 30 CFR § 206.102(c).

[21] 30 CFR.§ 206.102(b)(1)(ii).

circumstances.[22] Finally, all lessee value determinations are subject to MMS review, monitoring and audit.[23]

Yet for wholly unfounded reasons the MMS would essentially scrap the existing regulations in favor of an untried -- and previously rejected -- indexing scheme. Although the proposed index-driven methodology itself has the many flaws described below in Parts III and IV, its extraordinary sweep has independent significance. For non-arm's-length sales, the ordered benchmarks would be eliminated altogether in favor of an indexing scheme drawing on NYMEX or ANS prices with some adjustments for location/quality differentials and transportation.

Even arm's-length sales would be significantly affected. While the Proposal acknowledges " the presence of true arm's-length sales,"[24] for which a lessee could continue to use gross proceeds as the measure of value for royalty purposes,[25] the MMS plainly views such transactions as curiosities, expecting that only "a relatively small volume of Federal oil production would be valued using the arm's-length gross proceeds method."[26] Indeed, the regulations would employ sharply narrowed definitions of "arm's-length contract" and "sale"[27] and other provisions which would categorically exclude many commonly used transactions for crude oil disposition, such as exchange agreements (including buy/sell agreements) and crude oil calls.[28] In addition, gross proceeds would be

[22] 30 CFR § 206.102(e)(1).

[23] 30 CFR § 206.102(K).

[24] Proposal at 3744.

[25] Proposed § 206.102(a) at 3752.

[26] Proposal at 3744.

[27] Proposed § 206.101

[28] Proposal at 3744; proposed §§ 206.101 and 206.102(a)(4).

disallowed for calculation of royalty value, if there had been buy downs,[29] or if there had been any purchases of crude oil by the lessee (or any affiliate) from an unaffiliated third party in the two-year period proceeding the production month.[30]

But such a response is plainly overkill. Instead of "throwing the baby out with the bathwater," the MMS should consider revisions to the existing regulations in proportion to any real problems it finds upon further examination.

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[29] Proposed § 206.102(a)(5).

[30] Proposal at 3743; proposed § 206. 102(a)(6).

III. The Index-Driven Valuation Scheme of the Proposal Does Not Work

Despite the absence of any compelling reason to abandon the existing regulatory regime for valuation of crude oil, the Proposal would abandon it and replace it with an index-driven scheme based on either New York Mercantile Exchange ("NYMEX") or Alaska North Slope ("ANS") prices.

A. Use of NYMEX and ANS Spot Prices Generally

The use of futures or spot prices for royalty valuation was considered -- and rejected -- when the MMS' current oil regulations were drafted in 1987. The Associate Director for Royalty Management concluded that "for the purposes of oil valuation, the application of futures and/or spot prices would be either contrary to existing law, lease terms and regulations or too impractical and nonspecific to administer."[31] After carefully considering the use of futures and spot prices, the Associate Director concluded:

> More important is the basic conclusion that, even if the study results do indicate that oil futures prices "lead" posted prices, this has no bearing on our valuation purposes, we must apply market value existing at the time of production or sale. Whether postings are considered to lag futures prices or not, postings represent current offers to purchase oil and are adjusted as necessary to conform to market conditions. Further, oil futures and spot prices are available on such a limited basis as to make price adjustments for quality and/or transportation extremely difficult, if not meaningless.[32]

And the conclusions reached then still apply today. For example, in Engwall v. Amerada Hess Corporation,[33] Professor Kalt offered expert

[31] Memorandum from Jerry D. Hill, Associate Director for Royalty Management, to Director, Minerals Management Service, dated February 12, 1987 ("Hill Memorandum") at 1(emphasis added) (**Attachment E**).

[32] Hill Memorandum at 2.

[33] Engwall v. Amerada Hess Corporation *et al.*, CV-95-32, Fifth Judicial District, County of Chaves, New Mexico.

testimony,[34] based on a study,[35] that transactions at the lease level demonstrate that localized supply and demand factors that influence the market value of crude oil.[36] Such market values vary significantly with supply and demand factors specific to individual leases, crude oils and particular transactions.[37] Because supply and demand factors at the lease level and trade or market center level differ, use of NYMEX or P-plus as a valuation methodology could result in either huge under or over payments of royalties.[38]

The difference between market value at the lease and the price of crude oil at market centers based on a NYMEX future price generally reflects value added to the crude oil.[39] This added value comes about because of several downstream marketing functions, including the development of marketing information and expertise regarding types of crude oil, customer preferences for crude oil, and transaction handling costs.[40] Netting back from market center transaction prices without recognizing the value added by marketing functions produces a higher, but inaccurate value.[41] Even adjusting the net back methodology for gravity, sulfur and timing, the numbers are still inaccurate

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[34] Professor Kalt is a professor at Harvard University, Kennedy School of Government, and is a consultant with the Economics Resources Group. Professor Kalt testified on January 16 and 17, 1997 in the class certification hearing in Engwall v. Amerada Hess, *et al.*

[35] Professor Kalt's expert testimony was based on his study of approximately 886,000 monthly crude oil transactions during the1992-1996 period in Texas, New Mexico, and Oklahoma of sales and purchases in the field. Kalt Testimony at 1057-58 (**Attachment F**).

[36] Kalt Testimony at 1142-43.

[37] Kalt Testimony at 1144.

[38] Kalt Testimony at 1188-89; *see also* Affidavit of Marshall Thomas ("Thomas Affidavit") (**Attachment G**) ¶¶ 50-57, 69-74. Mr. Thomas is an oil market pricing analyst, active in the petroleum industry since 1967. He is senior vice president of PVM Oil Consultants, Inc., an affiliate of the international brokerage firm, PVM Oil Associates, Inc.

[39] Kalt Testimony at 1179-80; Thomas Transcript at ¶¶ 50-57.

[40] Kalt Testimony at 1182.

[41] Kalt Testimony at 1175, 1179-80.

because they may not reflect the particular supply and demand factors in many individual transactions.[42] The use of spot prices to value California and Alaska Cook Inlet crude is also flawed.

Even the Department of Energy (DOE) recently abandoned the use of spot prices in selling its own crude oil produced from the Elk Hills Naval Petroleum Reserve (NPR), California.[43] The DOE sells approximately 45,000 barrels/day of light sweet crude from Elk Hills to refiners in California. Until fairly recently, the DOE's sales contracts were based on the average of two spot prices, one of which was published for ANS production delivered by tanker to California. Having concluded that spot prices were unreliable, DOE abandoned spot prices.

One NPR official stated in the Inside Energy article, "Our conclusion is that now, at least, postings track the market. It is our feeling that postings do a fair job of representing the market today."[44] In the future DOE is expected to issue a report describing the role of futures market on stock, inventory level and price.[45] In any event, DOE's experience is that spot prices are particularly unreliable indicators of the market value of California crude.

Similarly, an Innovation and Information Consultants (IIC) study for the MMS regarding allegations of undervaluation of royalty oil in California examined California posted prices and the sale of crude oil produced from the National Petroleum Reserve (NPR). The IIC study showed that the higher prices received or NPR crude oil (compared to the posted prices) were related to such factors as the higher quality of the NPR crude oil.[46]

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[42] Kalt Testimony at 1180.

[43] *See* Platt's Oilgram News, Vol. 74, No. 63 (March 29, 1996), at 3.

[44] *Id.*

[45] Platt's Oilgram News, Vol. 74, No. 209 (October 28, 1996) at 4.

[46] Memorandum from Cynthia Quarterman, MMS Director, to Assistant Secretary, Land and Minerals Management, dated May 31, 1996 (**Attachment H**).

In sum, the MMS' 1987 conclusions on the use of NYMEX future prices and ANS spot prices are as sound today as they were in 1987. There is no support for the contentions that an average ANS spot price is the best indicator of market value at the lease for Federal California and Cook Inlet Alaska crude oil and that NYMEX is the best indicator of market value at the lease for all other domestic crudes.

B. Use of ANS Spot Prices

For Federal crude oil produced from California and Alaska leases disposed of under non-arm's-length sales contracts, the Proposal would use as its starting point for valuation "the average of the daily mean Alaskan North Slope (ANS) spot prices for the month of production published in an MMS-approved publication."[47] The MMS reasoned that average ANS spot prices for valuing California and Alaska Federal oil production are the best starting point for valuation because: 1. production is isolated; 2. ANS represents large volumes of oil delivered to California for refinery feedstock use; 3. MMS' consultants support ANS spot prices as best reflective of market value; and 4. using NYMEX with adjustments for California and Alaska crude oils would be difficult.[48]

However, using an average ANS spot price is <u>not</u> appropriate in valuing Federal crude oil produced in California or Cook Inlet Alaska. In 1987 the Associate Director of the MMS concluded that spot prices do not capture the quality and location differentials of different crudes and are only available for a few crude oils.[49] For example, the quality of ANS crude is significantly different than California OCS Federal crude oil produced from the Santa Ynez Unit. Whereas the API gravity on ANS is approximately 30 degrees with a 1% sulfur level, Santa Ynez Unit is less than 19 degrees with a 5% sulfur level. Yet, under the Proposal there is no adjustment for the quality differential between the

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[47] Proposal at 3753, proposed § 206.102(c)(2)(ii).

[48] Proposal at 3745.

[49] Hill Memorandum at 2.

California OCS crude and the ANS spot price when the California OCS crude is sold at a market center.[50] Because of the quality differences, the ANS spot price plainly does not reflect the quality of the California crude oil being sold in San Francisco and Los Angeles.[51]

In addition, while the ANS methodology is certainly questionable with respect to valuation of the California production, it makes even less sense to apply the methodology to Federal royalty oil in Cook Inlet Alaska. The crude oil produced from Federal leases in Alaska is produced from leases in the Cook Inlet (about 5000 barrels per day). The Cook Inlet crude oil, which is qualitatively quite different from the North Slope crude, is delivered to the Tesoro refinery located at Nikiski, Alaska where it is refined. Tesoro then sells the refined products in the local Alaskan market. To value this oil, which moves only a few miles from the point of production to the Tesoro refinery, by referencing sales of dissimilar crude oil that takes place more than 2000 miles away is nonsensical. To do so would require backing out phantom transportation costs, as well as making quality adjustments to account for the considerable differences between North Slope crude oil and Cook Inlet crude oil. Additionally, there would have to be a determination about whether to use the landed prices and transportation costs to San Francisco or Los Angeles since none of the Cook Inlet crude oil goes to either location and, in fact, never leaves Alaska.

In sum, the use of the ANS spot price as the beginning point for valuing California and Alaska Cook Inlet Federal crude oil for royalty purposes simply does not work.

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[50] 62 FR 3755, proposed § 206.105(3)(iii).

[51] Furthermore, the ANS published spot price reflects the value of ANS delivered in waterborne cargo volumes and is not indicative of the value of onshore California crude oils delivered by pipeline. Thomas Affidavit at ¶ 78.

C. Use of NYMEX

For production outside California and Alaska, the proposal contemplates use of the NYMEX light sweet futures contract price ("the NYMEX futures price") with certain specified adjustments. However, the NYMEX futures price is substantially different from the value of crude oil at the lease, and cannot be adjusted by means of a "one size fits all " methodology to arrive at market value at the lease. The NYMEX futures price reflects market conditions and forces that simply do not exist at the lease. Furthermore, the adjustments to the NYMEX futures price proposed by MMS fail to account for and correct the substantial differences between the NYMEX futures price and the value of crude oil at the lease.

1. Nature of NYMEX Futures Prices

NYMEX has existed in its present form since August 3, 1994, when New York's two largest commodities exchanges, the New York Mercantile Exchange and the Commodity Exchange, Inc. (COMEX), merged to become the world's largest physical commodity futures exchange. Each day trading in commodities futures is conducted through two divisions: the NYMEX Division, on which crude oil, heating oil, gasoline, natural gas, propane, platinum, and palladium trade; and the COMEX Division, on which gold, silver, copper and the Eurotop 100 stock index trade.[52]

NYMEX's trading floor is located in New York City. NYMEX has 749 individual members (with 816 seats on the exchange), consisting of brokers, bankers, refiners, marketers and individuals.[53] As NYMEX's own literature makes clear, physical supplies of the traded commodities are nowhere to be found in NYMEX's offices. Instead, NYMEX traders buy and sell "futures contracts." A

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[52] NYMEX Internet Documents ("NYMEX Inter. Doc.) at 8 (**Attachment I**).

[53] Thomas Affidavit at ¶ 13.

futures contract is a legally binding obligation to buy or sell a commodity, such as crude oil, at a specific price and location, at a specific future date.

With respect to crude oil, NYMEX has developed a standardized crude oil futures contract. The contract pertains only to the future sale of light, sweet crude oil, and is usually referred to as a NYMEX division light, sweet crude oil futures contract. Each NYMEX crude oil futures contract pertains to a fixed volume of crude oil, *i.e.*, 1,000 U.S. barrels (42,000 gallons). All such contracts provide for the same delivery point -- *i.e.*, F.O.B. seller's facility at Cushing, Oklahoma, at any pipeline or storage facility with pipeline access to ARCO's or Texaco Trading and Transportation Inc.'s Cushing storage.[54] NYMEX permits trading in its crude oil futures contracts for delivery in the next 30 consecutive months, plus certain "long-dated" futures contracts, including 36 and 48 months prior to delivery. Trading in the NYMEX crude oil futures contracts for delivery in a given month terminates at the close of business on the third business day prior to the 25th calendar day of the month preceding the delivery month.[55]

Although MMS refers to the NYMEX futures contract as if it pertained solely to West Texas Intermediate ("WTI") crude oil, a NYMEX futures contract can in fact be fulfilled with several different kinds of light, sweet crude oil. NYMEX has established that specific domestic crudes with 0.42 percent sulfur by weight or less, and not less than 37 degrees API gravity nor more than 42 degrees API gravity, are "deliverable" to fulfill a NYMEX crude oil futures contract.[56] NYMEX has deemed the following domestic crude oils to be "deliverable" under a NYMEX futures contract: West Texas Intermediate, Low Sweet Mix, New Mexican Sweet, North Texas Sweet, Oklahoma Sweet, and South Texas Sweet.[57] Similarly, NYMEX has deemed several specific foreign

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[54] NYMEX Inter. Doc. at 2-3; Thomas Affidavit at ¶ 14.

[55] NYMEX Inter. Doc. at 2-3; Thomas Affidavit at ¶ 14.

[56] NYMEX Inter. Doc. at 4.

[57] NYMEX Inter. Doc. at 4.

crudes, of not less than 34 degrees API nor more than 42 degrees API, to satisfy a NYMEX futures contract, including U.K. Brent and Norwegian Oseberg Blend (for which the seller receives a 30 cent per barrel discount below any contract settlement price), Forties (for which the seller receives a 35 cent discount), and Nigerian Bonny Light and Cusiana (for which the seller receives a 60 cent per barrel premium).[58]

The prices of NYMEX's crude oil futures contracts, like those of other NYMEX commodities futures contracts, are determined in an open and continuous auction on NYMEX's exchange floor in New York City by traders acting on behalf of anonymous sellers and buyers. The auction process is referred to as "open outcry." The process is similar to an auction, except that there are numerous sellers, as well as buyers, present at the open outcry; the sellers compete with each other to sell, driving down offering prices, just as buyers compete with each other to buy, driving up the bidding prices.

As the foregoing makes clear, what is bought and sold through NYMEX is not the crude oil itself, but futures contracts, *i.e.*, agreements to buy and sell the commodity at a certain place and future time. In the case of crude oil futures contracts, the place of delivery is specified as facilities in Cushing, Oklahoma, with access to other storage facilities and pipelines. The crude oils that may satisfy the contracts are the range of light, sweet crude oils described above.

The NYMEX crude oil futures contract is a commodity instrument, not a contract to sell an actual barrel of crude oil. On a good trading day, 150,000 contracts can change hands.[59] That is equivalent to 150 million barrels a day of crude oil, more than 15 times the average daily volume of crude oil production in the United States.

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[58] NYMEX Inter. Doc. at 4.

[59] Thomas Affidavit at ¶ 16.

2. Hedging and Speculation, the Principal Motivations for Trading in NYMEX Crude Oil Futures Contracts.

A major purpose of trading in futures contracts is to engage in hedging. Indeed, NYMEX's own literature states that: "Futures contracts are most widely used for hedging."[60] Buyers and sellers trade in the futures contracts to lock in the price and thereby avoid the risk that the market price will change significantly in the future. As time passes, the holders of futures contracts have numerous means of actually "closing out" their futures positions without actually taking possession of the commodity at the time and place specified in the futures contracts. As NYMEX's own literature states:

> Most hedgers, no matter what the commodity, close out their futures positions before the futures contracts expire, and then make or take their physical deliveries through the people with whom they usually buy or sell their actual supplies. Knowing that at any given time, however, someone may actually demand to buy your products, or sell theirs to you at that price, helps keep the value true to life.[61]

As NYMEX's literature also makes clear, NYMEX encourages the governments of oil producing nations such as Mexico, Norway and Columbia to trade in its crude oil futures contracts in order to hedge or mitigate financial risks associated with fluctuations in market prices and oil production revenues. Certain states, including Texas, Delaware and Massachusetts, have developed similar hedging programs.[62] At the same time, however, many major oil producing nations view NYMEX and its crude oil futures contract as "speculative," and refuse to link prices to such instruments.[63]

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[60] NYMEX Inter. Doc. at 9.

[61] NYMEX Inter. Doc. at 16.

[62] Thomas Affidavit at ¶ 20.

[63] Thomas Affidavit ¶ 21.

In addition to hedgers, other major participants in the trading of NYMEX's futures contracts include speculators. Speculators take positions in futures contracts, not as a hedge against price changes in commodities that they actually will sell or purchase at some location and future time, but in hopes of timing the market advantageously and making a profit. NYMEX describes the demand for futures by hedgers and pure speculators as follows:

> [H]edgers don't try to make a killing in the market. They use the futures to help stabilize revenues or their costs. Speculators, on the other hand, try to profit by buying low and selling high (or vice versa), taking a position in the futures market and hoping the market moves in their favor. Hedgers hold offsetting positions in the market for the physical commodity; speculators do not.[64]

NYMEX crude oil futures trading is, in fact, clearly dominated by speculative interests. With respect to participation in NYMEX (*i.e.,* crude futures - open interest) in 1996, producers of crude constituted only 3% of the market; integrated oil companies, refiners and marketers represented a combined 25% of the market; and "speculative interests" constituted the remaining 70% of the total volume of open interest.[65] If anything, the influence of speculative interests has increased, not decreased, since the late 1980s.[66] Speculative interests include traders, financial institutions (including funds) and other "speculators" on the trading floor.[67] As Mr. Thomas states, "Clearly, oil-the-commodity, *i.e.*, as the paper futures instrument that can be bought and sold at will without physically taking title to any crude oil, is the engine that drives NYMEX trade, and oil the

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[64] NYMEX Inter. Doc. at 9.

[65] Thomas Affidavit at ¶ 22.

[66] Thomas Affidavit at ¶ 22.

[67] Thomas Affidavit at ¶ 22.

physical barrel that moves from the wellhead is merely the foundation from which the futures market complex rises."[68]

3. NYMEX Prices Influenced by Forces Not Present at the Lease Market.

"The difference between a commodity futures benchmark like NYMEX [Division Light Sweet Crude] and physical wellhead supply are numerous."[69] First, although deliveries of physical oil can be made against a NYMEX crude oil futures contract, physical supply is not the primary rationale behind trade in such futures; rather, price considerations predominate.[70] The very ease with which futures contracts can be traded and closed out gives them added value over "the cumbersome physical barrel at the wellhead."[71]

Second, there is a structural differential built into the price of the NYMEX crude oil futures contracts.[72] The NYMEX contract is a structured trading instrument with numerous built-in administrative protections, including financial surveillance by NYMEX, audits, and the maintenance of the financial integrity of futures contracts through enforcement of position limits and margin requirements.[73] These features "enhance the value of the NYMEX crude oil futures contract prices (all other things being equal)."[74]

Third, the price of crude oil futures contracts is affected by matters involving timing and the prices of other futures contracts pertaining to delivery for

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[68] Thomas Affidavit at ¶ 22.

[69] Thomas Affidavit at ¶ 26.

[70] Thomas Affidavit at ¶ 26.

[71] Thomas Affidavit at ¶ 26.

[72] Thomas Affidavit at ¶¶ 28-29.

[73] Thomas Affidavit at ¶28; *see* NYMEX Inter. Doc. at 17.

[74] Thomas Affidavit at ¶ 28.

the same period. "Timing is a critical element. . . . Futures market participants earn their rewards, if any, by determining when to buy and sell specific supplies over the life of each contract."[75] MMS's proposal to use a rolling "prompt month" or "front month" NYMEX quote does not solve this fundamental difference between the futures market and the lease market. Such NYMEX quotes can still be impacted by matters involving speculation and timing.[76]

Finally, there are major differences between the lease markets and the market at Cushing, Oklahoma, associated with NYMEX futures contacts.[77] Unlike any single Fedeal lease, Cushing has approximately 25 million barrels of crude oil storage, and more than a dozen major pipeline linkages and interchange connections for Midwest destinations.[78] Given Cushing's substantial storage facilities and vast, interconnected pipeline systems, the Cushing reference location in NYMEX's crude oil futures contracts "gives the futures contract added value from a physical standpoint."[79] The seller of crude oil at Cushing is at a central distribution point with access to a large number of buyers, giving added value to his crude oil.[80] In contrast, the vast majority of crude oil produced in North America does not benefit at the lease from infrastructure and a pool of buyers so large as that at Cushing. The trading on NYMEX, involving contracts for 1,000 barrels of crude oil, and the trading at Cushing, take place on a different scale than the lease. The average oil well in the United States produces at a rate of 11.4 barrels per day, based on Independent Petroleum Association of America information.[81] The smaller stripper wells produce only about 2 barrels

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[75] Thomas Affidavit at ¶ 31.

[76] Thomas Affidavit at ¶ 32.

[77] Thomas Affidavit at ¶¶ 33-34.

[78] Thomas Affidavit at ¶ 34.

[79] Thomas Affidavit at ¶ 34.

[80] Thomas Affidavit at ¶ 34.

[81] Thomas Affidavit at ¶ 34.

per day on average, and the larger volume, non-stripper wells average about 41 barrels per day of production.[82]

In sum, the NYMEX futures prices are influenced by important forces not present at lease markets. As a result, crude oil values at the lease are fundamentally different from NYMEX prices.

4. No Simple, Consistent Relationship Between NYMEX Prices and Values at the Lease

While it is true that various entities valuing crude oil may "take a look" at NYMEX crude oil futures contract prices in the course of valuing crude oil for physical purchases or sales, there is no simple, mechanistic relationship between NYMEX futures prices and the value of specific non-NYMEX crude oils. Beyond the valuation that NYMEX places on generic light sweet crude delivered at Cushing, there is involved in crude oil valuation the additional component of "basis risk," *i.e.*, the difference that exists between the NYMEX value and the specific values of all other crudes.[83] These values vary from one crude oil to another due to differences in crude quality, location, gathering and transportation, infrastructure, timing, class of trade and many other factors. Moreover, linkages that exist between the values of many individual crude oils and the NYMEX futures price are as volatile as the NYMEX basis itself.[84] The result is that "[t]he prices of all other non-NYMEX crudes do not move in lock step with NYMEX."[85]

A differential tends to be built into the NYMEX futures price as compared to the value of crude oil at the lease. The reasons for this differential include: (1)

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[82] Thomas Affidavit at ¶ 34.

[83] Thomas Affidavit at ¶ 36.

[84] Thomas Affidavit at ¶ 37.

[85] Thomas Affidavit at ¶ 36.

the ease with which futures contracts can be traded as compared to the trading of physical barrels of crude oil; (2) the built-in "structural " differentials in futures contracts reflecting administrative protections; and (3) the premium prices received at Cushing reflecting vast differences between the market at Cushing and the market at the lease. Furthermore, forces that have a major impact on the value of the NYMEX futures contract, including speculative forces, play either no role or a substantially lessened role at the lease. Since the values of all crude oils do not move in lock-step with NYMEX futures prices, no simple or consistent means exists for relating the NYMEX futures price to the value of crude oil production at the lease.[86]

In sum, in proposing a simplistic means of relating the NYMEX futures price to the value of crude oil at the lease, MMS' methodology would produce royalty values that do not reflect the value of crude oil at the lease. Part IV of these comments shows in specific terms why the adjustments contemplated by the Proposal cannot be used to arrive at the value of production at the lease.

[86] Thomas Affidavit at ¶ 69-74.

IV. The MMS Proposal's Adjustments Do Not Link Index Prices with the Market at the Lease

Even though the MMS recognizes that it is the "lease value" of Federal crude oil on which royalties are owed,[87] this part complements Part III by showing that the adjustments and other implementing details of the Proposal alone do not permit arrival at the value of production at the lease.

While conceding that the "most difficult problem" with the Proposal is making appropriate location and quality adjustments,[88] the MMS fails to solve this problem because the Proposal ignores many downstream factors that affect the value of the crude oil, relies on spot prices at market centers, ignores price volatility, and unduly limits adjustments for transportation and other costs.

A. Factors Leading to Downstream Increases in Crude Oil Value

Citing Summit Resources, one of the experts relied on by the MMS in formulating its Proposal, the Thomas Affidavit shows that as crude oil moves downstream from the lease, several factors operate, tending to add value to the crude oil. Some of these factors involve physical handling operations: gathering, transportation, storage.[89] Marketing, however, can also involve the direct costs of NYMEX trading,[90] and overhead attributable to personnel, equipment, office

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[87] *E.g.*, Proposal at 3742; *see also* discussion in Part V-A, *infra*.

[88] Proposal at 3746.

[89] Thomas Affidavit at ¶¶ 51- 52.

[90] Thomas Affidavit at ¶¶ 29-30. Although the Proposal ignores trading costs incurred by a lessee, the MMS recognizes that these costs would be incurred if it took its royalty-in-kind. *See* MMS 1997 Royalty-In-Kind Feasibility Study: Preliminary Options for Consideration, March 10, 1997.

space, etc., interest on inventory,[91] and the fees of contract traders.[92] Less easily quantified, but no less real, are costs associated with the constellation of risks.[93]

What this means is that to arrive at the value of production at the lease, adjustments should not be limited to a sharply limited category of actual costs. It also means that the further downstream one begins in the process of valuation, the more difficult it is to arrive at the value of production at the lease.

Furthermore, The Proposal's focus on actual costs is inappropriate because, in most cases, the Proposal's imputed "sale" would be fictional. If a lessee chooses not to incur the risk and expense of participating in market center transactions, it would be wholly arbitrary for MMS to require the lessee to value the oil as if it did.

Moreover, most wellhead sales under the Proposal would have to be valued as if they were NYMEX transactions or sales at market centers. Yet nowhere does MMS justify or even explain why lessees who elect not to incur the costs and take the risks of participating in the NYMEX futures market or selling oil to market centers should be required to value the government's royalty oil as if they had. Since Federal lessees have no obligation to market Federal oil in the NYMEX futures market downstream from the lease, they should not be required to value the oil as if they had, much less without a sufficient adjustment for the additional costs and risks that would have to be incurred in order to do so.

B. Misplaced Reliance on Published Spot Assessments

MMS' Proposal relies on reporting services to define crude oil values at the following designated "market centers": Cushing, Oklahoma; Midland, Texas; St. James, Louisiana; Empire, Louisiana; Guernsey, Wyoming; and Los Angeles and San Francisco, California. To determine crude oil value at these market

[91] Thomas Affidavit at ¶ 55.

[92] Thomas Affidavit at ¶ 56.

[93] Thomas Affidavit at ¶¶ 53-54.

centers, the Proposal contemplates periodic MMS publication of a list of "acceptable" publications, which MMS defines as those frequently used by buyers and sellers, frequently mentioned in contracts, or employing "adequate survey techniques."

MMS' reliance on such published spot assessments is misplaced for two reasons. First, the number of transactions reported to the trade press for certain market center crude oils is too small to permit corroboration of such reported prices, thereby creating uncertainty as to the accuracy of reported assessments.[94] The Proposal ignores the fact that published assessments vary appreciably in quality.[95] In other words, several of the reported spot price assessments that MMS proposes to rely on to bridge the difference between NYMEX futures prices and market centers have reliability and accuracy problems. Yet nowhere has the MMS addressed this issue.

Second, the market center spot assessments made and reported by pricing services are partly based on buy-sell transactions, exchange agreements and similar transactions that MMS alleges are unreliable in the lease market.[96] The very kinds of transactions that MMS alleges are unreliable and cannot be used at the lease to value crude oil are built into, and form the basis of, the reported spot price assessments at the market centers. Ironically, the MMS would reject use of such transactions at the lease, yet rely on such transactions at market centers

Unreliability and inaccuracy aside, spot prices received in downstream market centers tend to be higher than prices received at the lease.[97] As noted previously, as title to crude oil changes hands and crude oil moves away from

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[94] Thomas Affidavit at ¶ 59.

[95] Thomas Affidavit at ¶ 62.

[96] Thomas Affidavit at ¶¶ 63-68.

[97] Thomas Affidavit at ¶¶ 84-88.

the lease, downstream events tend to add value to the crude oil,[98] causing crude oil values generally to be higher at market centers than at the lease.

In short, the spot prices reported at downstream market centers are very different from crude oil values at the lease and inappropriate for royalty valuation.

C. No Accounting for Price Volatility

The MMS' simplistic proposal to impose a fixed annual location/ quality adjustment ignores the fact that the relative difference in value between crude oil at two locations, even crude oil of precisely the same quality, is constantly changing throughout the year. For example, fluctuations between Cushing and Midland values for WTI have ranged from plus 40 cents per barrel over Midland to minus 20 cents per barrel in the space of a year.[99] The fluctuations in value become even greater when the crude oils are of somewhat different quality. For example, in prior one-year periods there have been fluctuations in value between LLS at St. James and WTI at Cushing of over $1.20.[100] There is great volatility between market centers and great volatility at the lease, resulting in volatility between market center prices and aggregation point prices.[101] MMS' proposed fixed location/quality adjustment "would fail to capture the volatility in relative values between the market center and aggregation points, and it would be based on stale data from a prior year."[102]

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[98] Thomas Affidavit at ¶¶ 50-57.

[99] Thomas Affidavit at ¶ 71 and Exhibit C, Table 4.

[100] Thomas Affidavit at ¶ 72 and Exhibit C, Table 5. Even oil delivered from a specific lease may vary in quality over time for various reasons (*e.g.*, discovery of new reserves, recompletion in different producing formations, etc.). Quality of oil at points of sale can also be affected by blending with other sources of oil, which are subject to changes in quality for the same reasons affecting a lessee's production. Moreover, quality at the points of sale can be affected by the depletion or other discontinuation of production from sources that had been delivered at the point of sale.

[101] Thomas Affidavit at ¶ 72.

[102] Thomas Affidavit at ¶ 70.

D. Unduly Limited Adjustments for Transportation Costs

While the Proposal recognizes that differences in location affect value, its combination of transportation allowances and location differentials is wholly inadequate to accomplish this.

First, proposed section 206.105 ("Determination of transportation allowances and other adjustments") would apply to lessees valuing crude at index prices, and permit deductions of "actual transportation costs" from the lease to a "market center", an "aggregation point", or an "alternate disposal point," as those terms are used in the Proposal. If the lessee sells at the lease, the lessee would not have any direct, "actual transportation costs" to show. If sales are made at an "aggregation point", the lessee would have transportation costs from the lease to that point, but would not have further transportation to a market center. The lessee thus would be deprived of some of the deductions necessary to account for the differences between market center prices and lease market prices.

Second, the Proposal's treatment of "alternate disposal point" transactions also is completely arbitrary and undeveloped. In the Proposal's example,[103] Wyoming Sour Crude that is transported to a Salt Lake City refinery is valued the same as West Texas Sour Crude traded at Midland, Texas, minus actual transportation costs between the lease and Salt Lake City. Although Salt Lake City is located hundreds of miles away from Midland, Texas, there is no allowance or location differential to account for the difference in value at these two locations. Absent also is any adjustment to account for quality differences between the produced crude and crude at Midland.

Third, the MMS Proposal also inexplicably selects NYMEX prices from one time period to arrive at the price applicable to a particular production month, and then, for purposes of calculating a location and quality differential for that production month, uses a published spot price based on a different price timing

[103] Proposal at 3748.

cycle.[104] Specifically, the Proposal's example suggests the use of October differentials for September production. Yet in the real world, traders would be using the September reported differentials to price September production. Thus, the differential a lessee would be allowed to deduct would be different from the real world differential that traders use at the time of sale. Such differences lead to inaccurate valuation for royalty purposes and interfere with the market itself by injecting another unfounded risk element into the crude oil transactions themselves.

Fourth, the MMS purports not to alter existing transportation allowance rules,[105] but the Proposal does exactly that by proposing to delete existing 30 CFR §206.55(b)(5). Under the current regulations, a lessee may apply for an exception to the requirement that non-arm's-length transportation allowances be determined in accordance with a complex "actual cost" formula if there exists a FERC or State-approved tariff for the transportation. MMS identifies two reasons that purportedly justify this monumental change, but neither stands.

The MMS incorrectly asserts that the use of actual costs instead of tariffs is "fair."[106] The tariff rate paid to a carrier by both an affiliated and a nonaffiliated producer are the same; there is nothing "fair" about limiting the transportation allowance available to the former but not the latter.

The MMS also asserts[107] that the existing requirement is no longer viable after Oxy Pipeline, Inc.[108] and Bonito Pipe Line Co.[109] Not only do these cases

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[104] Proposal at 3747.

[105] *E.g.*, Proposal at 3737 ("MMS is not proposing to change the existing methods to calculate transportation allowances").

[106] Proposal at 3746.

[107] *Id.*

[108] Oxy Pipeline, Inc., 61 FERC 61,051 (1992).

[109] Bonito Pipe Line Co., 61 FERC 61,050 (1992).

deal only with offshore pipelines, but the MMS itself recently rejected the agency's broad reading of these cases:

> Because of the plethora of circumstances distinguishing the dispositions of production being shipped on different pipelines operating on or across the OCS, the simple jurisdictional determination in Oxy cannot be used as a blanket determination for all production being transported on all OCS pipelines. Without FERC's ICA jurisdictional determination for each pipeline, MMS cannot discern whether each of the Appellants' tariffs are approved.[110]

Yet the same rationale argued by the MMS and rejected earlier in the appeal is cited as the basis for the MMS' decision in the Proposal to eliminate the existing exception to use the FERC tariffs across the board, not only offshore but onshore as well. MMS' unsupported conclusion that "the use of FERC approved tariff[s] [are] no longer a viable alternative" after Oxy and Bonito is clearly erroneous and does not justify elimination of §206.55(b)(5).

Third, MMS has failed to articulate any rational basis why the current regulations do not adequately protect the MMS' interest. When the current regulations were promulgated in 1988, MMS concluded that "it is unnecessarily burdensome and duplicative to recompute costs."[111] To simplify procedures for both the lessee and MMS, the existing regulations provide an exception to the requirement to compute actual costs where the lessor's interest is adequately protected, while retaining denial procedures as protection from unreasonably high tariffs.

Finally, for arm's-length and non-arm's-length transportation arrangements alike, the Proposal limits the adjustment to "actual transportation costs" and, therefore, ignores the following: inventory costs; scheduling costs; pumpover fees; carrier-defined loss allowances; carrier-administered quality banks; carrier-imposed treating charges and, accounting/overhead costs

[110] Torch Operating Co., MMS-94-0655-OCS at 5 (January 18, 1997).

[111] 53 FR 1188,1211(January 15, 1988).

associated with transportation. As the Affidavit of Mr. Thomas shows, "the difference in value of crude oil between one location and another is not solely due to the cost of transporting the oil."[112] With respect to transporting oil from a lease to an aggregation point, generally, "the crude oil gains value by being moved from the lease to a point where it it is aggregated with greater quantities of crude oil and where more buyers, and greater demand, are present."[113] When API's members entered into leases with the Department of the Interior, it was never contemplated that they would be denied the right to charge reasonable rates for services such as transportation.

E. Unduly Limited Adjustments for Other Costs

MMS appears to have made a conscious decision that certain risks and costs should be borne disproportionately, or in some cases exclusively, by the Federal Government's lessees.

First, the Proposal would categorically allow no deductions at all for marketing costs. But, as shown in Part V-B below, Federal lessees are not required to market Federal lease production away from the lease free of charge. MMS cannot, by regulation, impose a new obligation on Federal lessees to market Federal lease production away from the lease free of charge. If the value of Federal lease production is enhanced because of downstream marketing costs incurred by the lessee after the production has been put in marketable condition at or near the lease, the Federal Government is entitled to share in the enhanced value only if it is willing to share the costs incurred to obtain that enhanced value.

Second, even if marketing costs could be lawfully excluded, the Proposal mischaracterizes some quality adjustments as marketing costs. For example, blending costs are deductible as quality adjustments because the blending

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[112] Thomas Affidavit at ¶ 50-57.

[113] Thomas Affidavit ¶ 10.

process changes the quality of the oil being valued.[114] Similarly, the costs incurred to convert a wet lease barrel into a NYMEX futures barrel represent a change in the quality of the oil being valued. In each case, the costs incurred to convert a wet lease barrel into a NYMEX futures barrel are more accurately characterized as quality adjustments, not marketing deductions. Properly classified, even the Proposal acknowledges that adjustments are proper for these costs:

> If the value of oil determined pursuant to sec. 206.102 of this subpart is based upon a quantity and/or quality different from the quantity and/or quality at the point of royalty settlement approved by the BLM for onshore leases or the MMS for offshore leases, the value shall be adjusted for those differences in quantity and/or quality.[115]

Third, the Proposal inappropriately grafts onto the proposed index-driven valuation scheme limitations on deductions that exist under the current "gross proceeds" valuation methodology. While it might be appropriate to impose limitations (*e.g.*, limiting transportation allowances to actual costs incurred by the lessee and to 50 per cent of the ultimate sales value), such limitations have no place in a regulatory scheme where the imputed point of sale is a fiction. If MMS is going to assume a NYMEX transaction, it must also assume that costs would have to be incurred in order to engage in that transaction and, therefore, allow the deduction of those costs. MMS can not have it both ways.

In sum, the mechanics of the Proposal fail to arrive at "lease value." The Proposal's adjustments for location and quality differentials are unduly limited and wholly inadequate to take into account all of the costs and risks that differentiate market center values from the value of a wet barrel of oil at the lease where it is produced.

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[114] Davis Oil Co. v. Lujan.

[115] 30 CFR § 206.103 (emphasis added).

MMS itself notes that "the location/quality adjustments needed to derive lease value using NYMEX would involve considerable administrative effort for all involved" and asks commenters to suggest alternatives "on ways to value Federal oil production based on market indicators in the vicinity of the lease." [116] API submits that the adjustment scheme of the Proposal is not only difficult but unnecessary and that the best alternative is already in place: the existing rules. Nothing in the administrative record suggests that a change from the existing rules is needed, much less the radical change proposed by MMS.

[116] Proposal at 3746; *see also* Proposal at 3745 (the "most difficult problem" with the proposal is making appropriate location and quality adjustments when comparing the NYMEX crude with the crude produced)

V. The MMS Proposal Unlawfully Ignores the Market at the Lease and Expands the Obligation to Place Production in Marketable Condition

A. Market Value at the Lease

An active lease market exists, separate and distinct from any market remote from the lease such as market centers. As Part III of these comments shows, localized supply and demand factors influence the market value of crude oil at the lease.[117] Such market values vary significantly with supply and demand factors specific to individual leases, crude oils, and particular transactions.[118] Because supply and demand factors at the lease level differ from those factors at trade or market centers, use of NYMEX or ANS as a valuation methodology could result in either huge underpayments or overpayment of royalties.[119] This is the wrong result and the MMS has no authority to promote it.

Yet under the valuation methodology proposed by the MMS, the MMS would impose royalties on a value different than the value of the production at the lease. In assessing royalty based on the value of crude oil after the production is removed from the leased premises to remote locations and markets, MMS would exceed its statutory authority, exceed its contract rights and raise constitutional takings issues.[120]

Federal oil and gas leasing statutes determine the MMS' regulatory authority to determine the value of production on which royalties are due.

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[117] Kalt Testimony at 1142-43.

[118] Kalt Testimony at 1144.

[119] Kalt Testimony at 1188-89.

[120] Under the Administrative Procedure Act ("APA"), 5 U.S.C. § 706, a reviewing court shall:

> (2)hold unlawful and set aside agency action. . . found to be--
> (A) arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law;
> (B) contrary to constitutional right, power, privilege, or immunity;
> (C) in excess of statutory jurisdiction, authority, or limitations, or short of statutory right;
> (D) without observance of procedure required by law . . . .

Section 8(a) of the Outer Continental Shelf Lands Act requires the payment of royalty at a percentage "in amount or value of the production saved, removed, or sold from the lease."[121] Likewise, the Mineral Lands Leasing Act requires the payment of royalty at a percentage "in amount or value of the production removed or sold from the lease."[122]

The legislative history of the Outer Continental Shelf Lands Act shows that Congress recognized the need for fair leasing provisions which incorporate commonly understood terms of leases developed and in general use in the industry, and the terms of leases granted by coastal states under which operations on the Continental Shelf have been conducted.[123] Courts have relied on this statement of congressional intent to conclude that the Department of the Interior cannot reverse long-standing policies in existence prior to enactment of the Outer Continental Shelf Lands Act [124] In other words, MMS cannot abandon the general common law principles applying to market value royalty clauses in effect at the time the leases were negotiated and entered into.

The focal point of valuation is the wellhead, the point at which the production of oil and gas is severed from the ground. In United States v. General Petroleum Corp., the court construed the Mineral Lands Leasing Act: " royalties are payable on gas as it is produced at the well. It is the value of that gas which must be determined."[125] Given the similarity of the royalty provisions of the Mineral Lands Leasing Act and the Outer Continental Shelf Lands Act,

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[121] 43 U.S.C. § 1337(a).

[122] 30 U.S.C. § 226(b).

[123] H. Rep., No. 2078, 81st Cong., 2d Sess. at 9-10 (1950).

[124] *See, e.g.,* Amoco v. Andrus, 527 F. Supp. 790 (E.D. La. 1981) (MMS cannot change longstanding policy allowing for free use of beneficial fuel gas or unavoidably lost gas).

[125] United States v. General Petroleum, 73 F. Supp. 254 (S.D. Cal. 1947).*See also* Marathon Oil Co. v. United States, 604 F. Supp. 1375, 1385 (D. Alaska 1985), *aff'd.*, 807 F. 2d 759 (9th Cir. 1986), *cert. denied*, 480 U.s. 940 (1987): Mobil Producing Texas v. New Mexico, Inc., 115 IBLA 164,171(1990)("normally gas is sold and valued for royalty purposes at the wellhead").

General Petroleum should apply equally to onshore and OCS leases. Where the MMS has attempted to impose royalties on something other than the value of the production saved, removed or sold from the leased premises, the courts have declared the agency's action to be in excess of its statutory authority.[126]

Just as in any contract, the parties to an oil and gas lease are entitled to rely upon the terms of the lease they enter into. A typical OCS lease form provides for royalties on the "amount or value of production saved, removed, or sold from the leased area."[127] Likewise, a typical onshore lease form provides for royalties on the "production removed or sold from the leased lands."[128] The oil and gas leases that private parties enter into with the Department of the Interior are contracts of the United States. When the Federal Government enters into contracts, such as the oil and gas leases at issue here, "its rights and duties therein are governed generally by the law applicable to contracts between private individuals."[129] The Department is bound by the contract terms of the lease as any private lessor would be.[130]

MMS cannot unilaterally amend the terms of Federal oil and gas leases. In instances where the Federal Government has specifically set out to abrogate the essential bargain of contracts to which it is a party, the United States Supreme Court has declared such abrogation to amount to impermissible repudiation.[131] Unless a lease expressly provides otherwise, the "property rights

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[126] *See, e.g.*, Diamond Shamrock Exploration Co. v. Hodel, 853 F.2d 1159 (5th Cir. 1988).

[127] Form 3300-1 (February 1971).

[128] Form 3120-9 (September 1985).

[129] *Lynch v. United States*, 292 U.S. 571, 579 (1934)

[130] *See, e.g.*, Rosebud Coal Sales Co., Inc. v. Andrus, 667 F.2d 949 (10th Cir. 1982) (oil and gas lease issued under the Mineral Lands Leasing Act created a commercial relationship and court applied typical contract law applicable to commercial transactions).

[131] *See*, e.g., United States v. Winstar, 116 S.Ct. 2432, 2479 (1996) (Scalia, J., concurring); Lynch v. United States, 292 U.S. 571, 578-80 (1934); Perry v. United States, 294 U.S. 330 (1935).

of the lessee are determined only by those rules in effect when the lease is executed."[132] Without express authority MMS cannot unilaterally change the point of royalty valuation, thereby abrogating the essential bargain of the oil and gas lease.

The MMS Proposal also raises constitutional takings issues. The Fifth Amendment prohibits the United States from annulling previously created contract rights.[133] Three facts are relevant to whether a Fifth Amendment taking has occurred: (1) the economic impact of the regulation on the claimant; (2) the extent to which the regulation interferes with the party's investment-backed expectations; and (3) the character of the government action.[134]

As to adverse economic impact on Federal lessees, the Proposal attempts to capture any value added to the royalty share of production after it is removed from the lease. As to investment-backed expectations, when lessees entered into oil and gas leases with the Federal Government, lessees relied upon the valuation terms of the lease to determine the economics of a transaction; changing the valuation point from that specified in the lease changes those expectations since it directlly affects the royalty burden of Federal oil and gas leases. Finally, the character of the government action is to permanently expropriate value added to the production by downstream marketing efforts. Based upon the standard articulated by the United States Supreme Court, the valuation scheme contemplated by the Proposal amounts to a Fifth Amendment taking.

In sum, movement of the royalty valuation point downstream of the lease to capture the value of crude oil at a location away from the lease violates the

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[132] Union Oil Co. of California v. Morton, 512 F.2d 743, 748 (9th Cir. 1975); *See*, Pauley Petroleum, Inc. v. United States, 591 F.2d 1308, 1325-26 (Ct. Cl. 1979), *cert. denied*, 444 U.S. 898 (1979).

[133] The Fifth Amendment states "nor shall private property be taken for public use, without just compensation." U.S.Constitution amend. V.

[134] Connolly v. Pension Benefit Guaranty Corp., 475 U.S. 211, 225 (1985).

terms of Federal oil and gas leases, exceeds the MMS' statutory authority, and constitutes an unconstitutional taking.

B. Expansion of Obligation to Market

In proposing that Federal lessees be required to market oil at no cost to their Federal lessor, the MMS would create a fundamentally new obligation. However, there is no existing statutory, contractual or regulatory requirement that a Federal lessee market production away from the lease at no cost to the Federal Government. Nor is there any authority to create one.

In its Proposal, the MMS equates the requirement to place production in marketable conditions with the duty to market, describing the proposed change as a mere clarification: "We did modify the paragraph on your obligation to place oil in marketable condition at no cost to the Federal Government to clarify that it includes a duty to market the oil."[135] However, the regulatory obligation to put production in marketable condition is not the same as an obligation to market production at no cost.

The existing MMS regulations provide: "The lessee is required to place oil in marketable condition at no cost to the Federal Government unless otherwise provided in the lease agree " mutual benefit of the lessee and lessor,"[136] which is inconsistent with the lessee absorbing all marketing costs.

MMS' current regulations also define the phrase "marketable condition" as "lease products which are sufficiently free from impurities and otherwise in a condition that they will be accepted by a purchaser under a sales contract typical for the field or area."[137] Notably, this definition focuses on the physical condition that the production must be in so that it can be marketed under contracts typical where the production occurs. In other words, under the current "marketable

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[135] 62 FR 3746 (emphasis added).

[136] 30 CFR § 206.102(b)(1)(iii)(emphasis added).

[137] 30 CFR § 206.101.

condition" regulation, the only thing that a lessee is required to do at no cost to the lessor is to place the production in the physical condition necessary to market it under contracts typical for the field or area. Additional costs are not even remotely contemplated by the marketable condition rule. Notwithstanding the Proposal's glib clarification, once production is in marketable condition, a Federal lessee's obligation under the marketable condition rule ends. Even if the lessee has an implied duty to market, that still does not justify the lessee being required to bear all marketingcosts.

After a marketable product has been obtained, the further costs of improving or transporting such product should be borne by both lessor and lessee.[138] The determination of who bears a particular cost depends on by whether the cost is properly identified as a production cost or as a post-production cost. Traditionally, the lessee bears production costs but shares post-production costs, such as marketing costs proportionately with the lessor.[139]

While MMS asserts that its cost free marketing clarification is "consistent with several Interior Board of Land Appeals decisions," the only authority it cites is a decision of the Interior Board of Land Appeals in Walter Oil and Gas Corp.[140] However, the Department cannot create new lease obligations by administrative decision any more than it can imply them through self-serving attempts to "clarify" pre-existing regulations. Because the lessee is required by regulation to put production in marketable condition, it does not follow that the lessee must assume the additional costs of marketing.

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[138] Kuntz, E., A Treatise on the Law of Oil and Gas, Vol. 5, § 39.4, p. 299 (1989).

[139] *Id.*

[140] 111 IBLA 265 (1989). Existing judicial authority stands only for the proposition that Federal lessees are obligated to put production in marketable condition at no cost. *See* California Co. v. Udall, 296 F.2d 384 (D.C. Cir. 1961) (costs for compression, dehydration, and conditioning to meet pipeline specifications); Mesa Operating, Ltd. v. U.S. Department of the Interior, 931 F.2d 318 (5th Cir. 1991) (costs of compressing, gathering, processing, treating, liquefying or transporting); Shoshone Indian Tribe v. Hodel, 903 F.2d 784 (10th Cir. 1990) (compression and administrative costs associated with processing).

VI. The MMS Should Fully Explore Royalty-in-Kind Before Abandoning the Existing Crude Oil Valuation Regulations

If the MMS has reservations about valuation, it could, as suggested above in Part II, explore revisions to the existing regulations instead of abandoning them. However, to the extent the MMS takes its royalty-in-kind, it could obviate valuation complications and controversy altogether. Indeed, the royalty-in-kind option sparked considerable interest at the MMS' March 18 and 19 royalty-in-kind meetings and was a recurring theme in the testimony offered at the MMS' April 15 and 17, 1997 meetings on this Proposal which encompasses royalty-in-kind.

For a royalty-in-kind program to work, it should exhibit four basic attributes:

First, the lessee's royalty obligation must be completely satisfied upon reporting and tendering of the royalty barrels in marketable condition to the lessor, MMS. Upon tender of the royalty share, all risk of loss must pass from the lessee to the lessor. And, although the MMS may choose to pass on the risk of loss to a third party purchaser, it is both inequitable and impractical to hold a lessee liable if a third party purchaser fails to take and pay for the MMS royalty barrels.

Second, the lessor must take the royalty barrels tendered by the lessee. As consideration for a bonus and a royalty free of production costs, the MMS has given up its right to operate the lease. The MMS has no right under the lease to defer its take obligation, or leave its production in the ground.

Third, when the lessor elects to take its royalty in kind, neither the duty to market the royalty share, nor the obligation to bear marketing costs, may be imposed on the lessee. The Federal lease gives the MMS two mutually exclusive options: the option to be paid royalty in value or in kind. The lessee's duty to market production for the mutual benefit of lessor and lessee arises only when royalty is paid in value. However, when MMS elects to be paid in kind, no duty to market the royalty share is imposed on the lessee. In Part IV of these comments, API showed that the lessee has no duty to market the royalty share; it certainly cannot be forced to bear any marketing costs associated with royalty barrels.

Fourth, for simplicity, the royalty delivery point must be the same as the point of royalty settlement and both must be at or near the lease. Current regulations, which the MMS does not propose to change, state that royalties shall be computed on the quantity and quality of oil as measured at the point of settlement approved by BLM or MMS.[141] It is impractical to establish a royalty in kind delivery point downstream of the royalty settlement point because quantity and quality will invariably be altered as the oil moves away from the royalty settlement point. Further,it would be inequitable to establish a royalty delivery point/settlement point away from the lease because lessees would, in effect, be forced to incur additional costs to deliver the royalty share downstream, giving rise to disputes about marketing costs and allowable deductions. This would be especially burdensome on lessees who sold their own share of production at the wellhead, requiring additional marketing expertise and special accounting practices.

API urges the MMS to continue its investigation of the royalty-in-kind option for valuation of crude oil.

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[141] 30 CFR §106.103(a).